IT 98-0020-GIL 02/20/1998 COMBINED UNITARY RETURN

General Information Letter: Adjustments to tax basis in stock of unitary subsidiary.

February 20, 1998

Dear:

This is in response to your letter dated January 13, 1998, in which you request a letter ruling. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information we have enclosed a copy of 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department.

Although you have not specifically requested either type of ruling, the nature of your question and the information provided require that we respond only with a GIL.

In your letter you have stated the following:

> xxxxxxxxx, xxx. and Subsidiaries files a consolidated U.S. Corporation Income Tax Return and an Illinois Combined Unitary Return. Not all subsidiaries are required to file an Illinois return. In fact, most do not have nexus in Illinois.
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> I have recently learned that California, a combination state, does not follow the consolidated return regulations with respect to tax basis adjustments made to subsidiaries pursuant to Treasury Regulation 1.1502-32. This creates a different basis in the subsidiary for California reporting purposes and a California gain or loss modification upon the sale or disposition of the sub.
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> An example illustrating the consolidated return principle may help. If a subsidiary is purchased by the parent company for $100, its basis in the entity is $100. If the sub generates $400 of taxable earnings and profits over the next 5 years, the consolidated return rule indicates that the parent's basis in the sub is increased by the $400 to $500. If the sub is then sold for $800, a $300 gain is generated for federal purposes. In disregarding the consolidated return rule, California would maintain that the basis was $100 resulting in a gain of $700 at time of sale (and a $400 gain modification). The concept is somewhat incongruous because being a combination state, California has already subjected the $400 of earnings to California tax. Accordingly, a "step-up" in basis should result. Nevertheless, California maintains that it never adopted the consolidated return rules and therefore a gain or loss modification upon sale of a sub will result. What is the Illinois rule with respect to this principle? Must Tektronix report an Illinois gain or loss modification upon the sale of one of its subsidiaries?

Ruling

Under Section 203(b) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq*.), the computation of the "net income" of a corporation begins with "taxable income," to which various addition and subtraction modifications are made. Section 203(e)(2)(E) of the IITA defines "taxable income" to mean:

> In the case of a corporation which is a member of an affiliated group of corporations filing a consolidated income tax return for the taxable year for federal income tax purposes, taxable income determined as if such corporation had filed a separate return for federal income tax purposes for the taxable year and each preceding taxable year for which it was a member of an affiliated group.

Pursuant to this provision, a corporation which sells its stock in a subsidiary with which it files federal consolidated income tax returns would compute its gain or loss on the sale without taking into account the adjustments to its basis in that stock required by the federal consolidated return regulations.

There is a significant exception to this rule if the corporation and its subsidiary are members of a unitary business group and file a single combined return. Beginning in 1985, corporate members of a unitary business group were allowed to elect to file combined returns. Starting in 1993, corporate members of a unitary business group are required to file combined returns. Section 502(e) of the IITA provides:

> For taxable years ending on or after December 31, 1985, and before December 31, 1993, taxpayers that are corporations (other than Subchapter S corporations) having the same taxable year and that are members of the same unitary business group may elect to be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in the election to file the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act. This subsection (e) does not permit the election to be made for some, but not all, of the purposes enumerated above. For taxable years ending on or after December 31, 1987, corporate members (other than Subchapter S corporations) of the same unitary business group making this subsection (e) election are not required to have the same taxable year.
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> For taxable years ending on or after December 31, 1993, taxpayers that are corporations (other than Subchapter S corporations) and that are members of the same unitary business group shall be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in filing the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act.

Section 1402(b) of the IITA provides:

> Group administration for taxpayers that are members of a unitary business group.
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> (1) For taxable years ending before December 31, 1993, the Department shall make, promulgate and enforce such reasonable rules and regulations, and prescribe such forms as it may deem appropriate, to permit all of the taxpayers that are corporations (other than Subchapter S corporations) having the same taxable year and that are members of the same unitary business group to elect to be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in the election to file the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act. For taxable years ending on or after December 31, 1987, corporate members (other than

Subchapter S corporations) of the same unitary business group making an election to be treated as one taxpayer are not required to have the same taxable year. The rules, regulations and forms promulgated under this subsection (b) shall not permit the election to be made for some, but not all, of the purposes enumerated above.

(2) For taxable years ending on or after December 31, 1993, the Department shall make, promulgate and enforce such reasonable rules and regulations, and prescribe such forms as it may deem appropriate, to require all taxpayers that are corporations (other than Subchapter S corporations) and that are members of the same unitary business groups to be treated as one taxpayer for purposes of any original return, amended return, which includes the same taxpayers of the unitary group which joined in filing the original return, extension, claim for refund, assessment, collection and payment and determination of the group's tax liability under this Act.

Pursuant to this authority, the Department has promulgated 86 Ill. Adm. Code Section 100.5270(a), which provides:

Determination of base income. The combined base income shall be determined by first computing the unitary business group's combined taxable income and then modifying this amount by the unitary business group's combined Illinois addition and subtraction modification amounts.

1) Combined taxable income. The designated agent will determine combined taxable income by treating all members of the unitary business group (other than ineligible members) as if they constituted a federal consolidated group and by applying the federal regulations for determining consolidated taxable income. (See IRS Reg. Section 1-1502-11, 26 CFR 1.1502-11.)

Under this regulation, which adopts the federal consolidated return regulations by express reference, a corporate taxpayer which sells its stock in a subsidiary must adjust its basis in that stock for each year for which the taxpayer and its subsidiary joined in the filing of a combined return according to the same principles applicable to a corporate taxpayer and a subsidiary which join in the filing federal consolidated returns.

In conclusion, the parent company in your example, which files consolidated federal income tax returns and combined Illinois income tax returns with its subsidiary, would adjust its basis in its stock in the subsidiary each year by the same amount for Illinois income tax purposes as it does for federal income tax purposes. If, on the other hand, the parent and subsidiary did not join in a combined Illinois income tax return for a year (for example, if no election were made for a year prior to 1993), no adjustment to the parent's basis in its stock in the subsidiary would be made for that year.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200. Please note, however, that a PLR cannot apply the law to a hypothetical situation and a PLR is not binding with respect to a statement of facts which is incomplete or incorrect. Accordingly, the Department does not ordinarily issue PLRs in response to requests based on unsupported conclusions of fact or which are, in effect, requests for determinations of fact. Given the inherently factual nature of the issues in your inquiry, we believe it is unlikely that we will be able to issue a PLR in this instance.

Sincerely,

Paul S. Caselton
Associate Chief Counsel -- Income Tax